

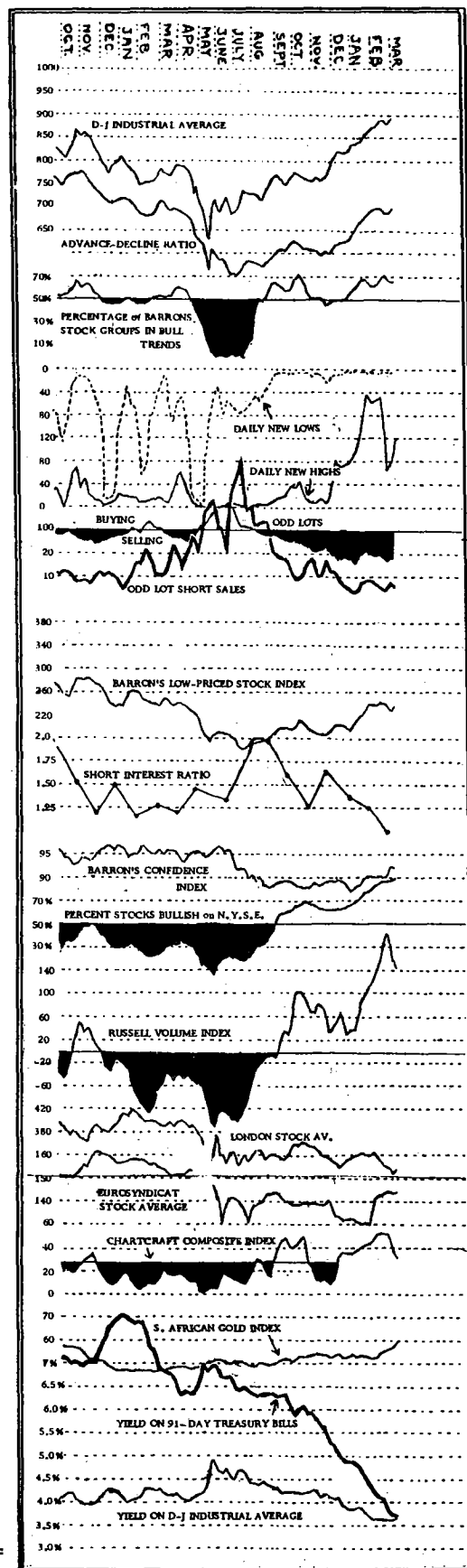
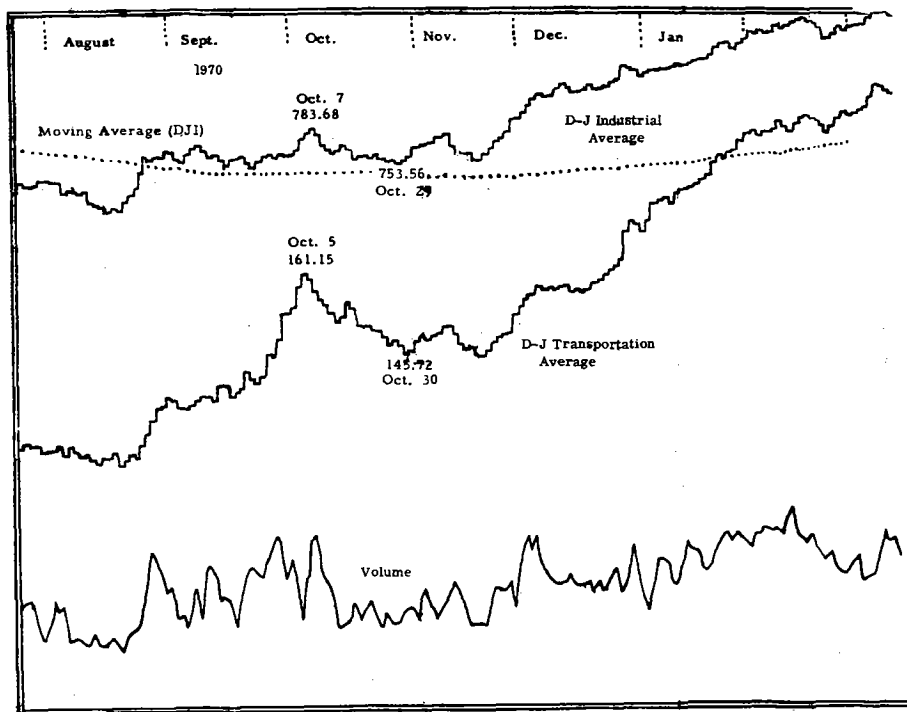
March 12, 1971

Letter 490

**THE PICTURE:** As I watched President Nixon's "foreign policy news conference" last week, I found myself asking, "Where does he stand? What is he really aiming at? Does our Air Force's backing of the invasion of Laos really have anything to do with getting U.S. troops safely out of South Vietnam?" My conclusion was that Mr. Nixon takes no firm stand anywhere, that whatever he wants is hazy or not in the open. To any one who likes clarity, purpose, a stand, the conference was an exercise in frustration. Despite myself, I found that I was framing cynical retorts to each of Mr. Nixon's answers on TV.

This morning, as I sat down to write this section, I realized that it is much the same in the area of the national economy. From his election stand of fighting the great menace of inflation, Mr. Nixon has turned to his new-found "Keynesian" philosophy. Even while inflation turns utterly rampant, the President is ignoring unbelievable wage settlements, and galloping price rises, while goading the Federal Reserve Board to continue accelerating the money supply. Today's paper carries the headline, "Nixon Weighs Tax Cut Speedup if Current Economic Plans Fail". Under this kind of fiscal recklessness, the bear market correction is being fueled by promises and hopes that can only lead to worse trouble on Wall Street and elsewhere than can be envisioned by the stoutest of today's remaining bears.

A subscriber writes, "At what point could we call this a primary bull market?" To me, it is like asking a doctor who is caring for a heart patient by pumping him full of ever-larger doses of adrenalin, "Doctor, at what point can we call him well?" Now the adrenalin doses may put the heart patient on his feet in no time flat, and he might look better (or more hopped-up) than you and I. But there's nothing well about him. And there is nothing "well" about this market.



The market has suffered from two heart attacks since this primary bear market began. The first attack (1966) erased 251 points on the Dow, the second (1968-70) erased 354 points. The third attack will, in my opinion, be fatal, and in a later section of this Letter ("The Storm") I hazard my guess as to how far the market will descend.

It is important to note, however, that most primary bear markets last about one-third to one-half as long as the preceding primary bull market. Since the 1949-66 bull market lasted 17 years, one might conclude that this bear market (which began in 1966) would last about 5 to 8 years and end about 1971 to 1974.

However, there is not a move towards correction in the fiscal or economic sphere that is not immediately counteracted by the Administration or the Federal Reserve Board. This is leading me to the uncomfortable conclusion that we are probably facing the longest and perhaps the most severe primary bear market in Wall Street annals.

It is important to remember that no malfunction can be extended indefinitely. If your auto engine has a faulty valve, you may "cover up" by gunning the engine, and in that way keep your car going for a while, even while giving it increasingly more gas to make up for the dropping cylinder pressure. But ultimately, the engine is going to break down. The trouble is fundamental, and no monkeying with the accelerator is going to do the job for long. It is the same with the economy. The system is balanced precariously between inflation and vanishing profits, between an increasing money supply and the cyclical forces which have turned down. And despite the barrage of new inflation, new fiat money and hysterical propaganda, the economic engine is panting harder than ever. Sooner or later (and the time is drawing near), all the malfunctions are going to start striking together. At that point, there won't be enough manipulatory devices in the whole Government combined to stave off the forces of the bear.

Liquid liabilities or all liquid claims by foreigners have risen from \$10 billion in mid-1969 to \$12 billion in early-1970 to about \$22 billion today. These accelerating claims are piling up against our total reserve assets (including gold, SDR's, foreign currencies and other assets) of about \$14.5 billion. Now, with interest rates in the U.S. well below comparable foreign levels, money will flow out of the U.S. and into higher-yielding foreign vehicles, thus pushing liquid liabilities even higher. Thus, even while the Fed floods the U.S. commercial banks with money, even while the Fed depresses interest rates via open-market operations, a counter-force is bringing new danger, and that danger is a withdrawal of assets from the U.S. and into foreign investments.

Multiply this phenomenon along dozens of other fronts, and you can see why the forces of the primary bear market can only be held back — not stopped. And the greater the manipulations, the longer the period of manipulation, the worse the results when the economic machine staggers, gasps and ultimately comes to a halt.

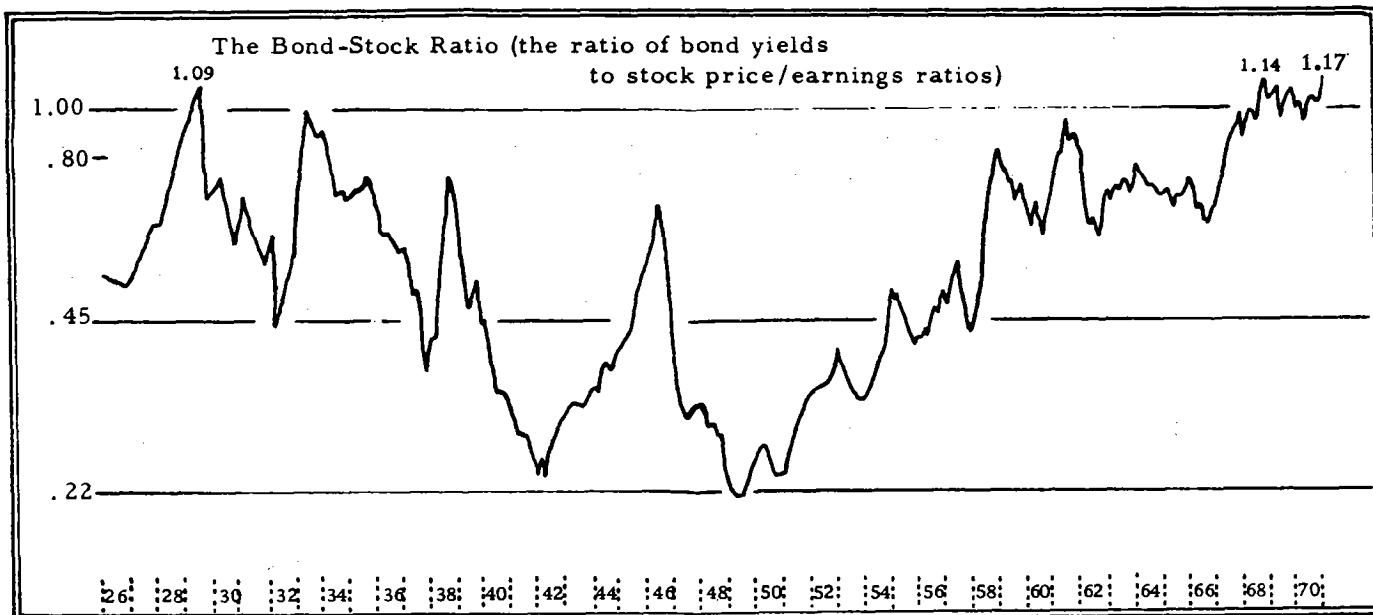
As to the near-term market, the Dow is now within a fraction of the 900 level, and although "irregularities" may often be expected as an important "psychological barrier" is approached, it is nevertheless worth noting that daily New Highs receded as the Industrial Average rose to within a whisker of 900.

On March 5 (Dow closed at 898.00) daily new highs were 187, on March 8 (Dow at 898.62) new highs were 163, on March 9 (Dow 899.10) new highs were 156. The decline in new highs was the more remarkable in that the advance-decline ratio rose on each of those days (although as of this writing the A-D ratio has failed to better its recovery peak of February 16).

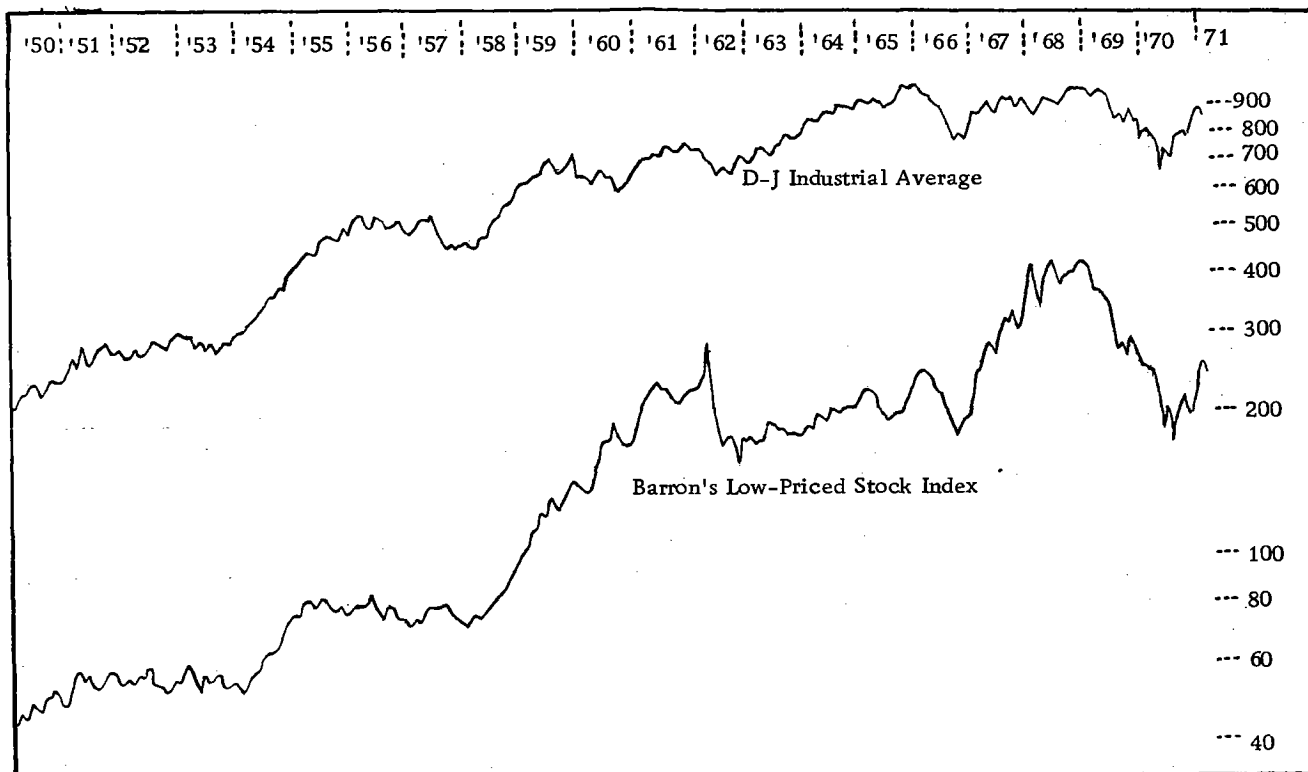
Thus, one strong day on the upside could put the Dow over 900 with other indicators in gear — or we could be seeing the beginning of trouble just under the 900 level. At this writing, unfortunately, it is too early to tell. It is well to remember, however, that many famous reversals have occurred just a hair away from a level which was considered "in the bag", such as the 900 level today. Perhaps the last such outstanding reversal came at the bull market top (995.15) of 1966, just 4.85 points short of the 1,000 level.

**STRAIN:** On the week ending March 5, Barron's listed the stock-bond ratio at 1.17, a new high in the history of this ratio. This is the ratio which measures price/earnings ratios on common stocks as against bond yields (not to be confused with stock yields as against bond yields).

The rationale behind the stock-bond ratio was explained in Letter 485, and I am up-dating the ratio chart (page 3) so that subscribers can see the dangerous heights to which this ratio has climbed. Only twice before in history has the stock-bond ratio climbed steadily to a level near or above 1.10. The first time was 1929, at which time the ratio halted at 1.09, to be followed by the worst bear market in Wall Street annals. The second time was in December, 1968, when the ratio rose to 1.14. This was followed by the worst bear decline since 1937. In the face of the recently declining bond market (with accompanying rising bond yields), the stock-bond ratio has now risen to its highest level on record.



Only three factors can bring the ratio down at this point: (1) a rising bond market, which is dubious in the face of the record monthly offerings, (2) rising corporate earnings, which would reduce price/earnings ratios on stocks, or (3) a decline in the stock market, which would also reduce the price/earnings ratios on stocks. At this level on the stock-bond ratio, I would say that past history suggests that it will be factor 3 which will come into play. Although the stock-bond ratio is hardly an exact timing device, it tends to show where we are in the super-cycle. We have never been further along.



**LOW-PRICED STOCK INDEX:** I have always been fascinated with the movements of the low-priced stock indices as compared with the movements of the D-J Industrials. In Barron's (December 1, 1958) I wrote an article entitled "Dow Theory Revisited". The main thesis of that article was that despite the intense pessimism and gloom of the times, a great stock market boom was in the making.

Page 4      One of the arguments which I used in the article was that Barron's Low-Priced Stock Index had never (since 1949) even approached its high of 170, recorded at the bull market top of 1946, at which time the Dow Industrials were 212. In 1958, with the Dow at 500, it appeared to me absurd that a major bull market might have topped out without an ultimate blow-off in low-priced stocks, a blow-off which would carry the Low-Priced Index far above its 1946 high of 170.

As matters turned out (see accompanying chart, page 3,) the 1957-58 bottom was followed by one of the greatest percentage rises in low-priced stocks in Wall Street annals (the chart is drawn to ratio scale, so that it shows percentage of rise or decline).

The primary bull market continued to February, 1966. Note that the first leg of the primary bear market (February to October, 1966) produced little in the way of downside action in Barron's L-P Stock Index. In fact, the Index held stubbornly above its 1962 low. This suggested that speculative interest was only slightly disturbed by the downward action which took the Dow from the 1966 high of 995.15 to the late-1966 low of 744.32.

The extraordinary upward correction of 1967-68 took the Dow Industrials to within 10 points of the 995.15 peak of 1966. But the L-P Stock Index roared to an all-time high of 413, under the impetus of one of the greatest orgies of Government-induced monetary stimulation in American financial history.

This massive counter-trend (upward) movement ended in December, 1969. During the next 17 months the L-P Stock Index sustained a huge collapse, dropping to a July, 1970, low of 170. Thus the L-P Index lost almost 60% of its value during 1969-70 (against a loss of 36% for the Dow).

Interestingly enough, the recent recovery since mid-1970, has seen the Dow Industrial Average recover about 74% of its 1969-70 losses. But Barron's L-P Stock Index, in rising from the 1970 low of 170 to the 1971 peak of 245, has recovered only 31% of its losses.

There are two ways of looking at this. A bull might say, "Well, if that's the case, there should be plenty of yardage ahead for this market, because the L-P Stock Index should surpass the percentage gains in the Dow before this up-move is over." I believe that those who hold this view are going to be proved wrong. Such thinking would be logical enough if this were actually a primary bull market. It would represent the same kind of thinking I used in my "coming boom" thesis of 1958.

But during a primary bear market, there comes a time when speculative sentiment is shattered. My own feeling is that the 60% drop in the L-P Stock Index indicated a "partial shattering" of speculative sentiment, in that it was the worst break in the L-P Stock Index since 1937. Had Barron's L-P Index sunk to around 100, I would say that the disillusionment had been complete. But nothing that drastic did occur.

Nevertheless, as a primary bear market progresses it is normal for speculative interest to die out, never to be revived in full until the latter stages of the next primary bull market. I must admit, however, that even I am surprised at the gingerly rise of the L-P Stock Index during the 1970-71 recovery. To me, the L-P Index acts as if it "wants" to go much, much lower on the next major downward leg of the bear. In fact, during the third and final phase of this most extended bear market in all history, I expect Barron's L-P Stock Index to sink well below 100, probably in the 50 to 75 area. Such action would signal the final collapse of speculative sentiment. I believe that we are going to see this kind of action during the next few years, see it as surely as night follows day.

THE STORM: A few days ago I perused the local paper, and I felt my mind boggle. In New York, 6,000 teachers were to be laid off, the state of Pennsylvania could not pay its employees and needed a 5% sales tax to stave off bankruptcy, the U.S. was sending "rescue" troops into Laos to attempt to bring out lost flyers, President Nixon had invoked the old Bacon-Davis act, which promises to be totally ineffectual in halting inflation in the construction trades, and on the financial page the bond market was faced with March offerings of \$3.5 billion, the heaviest load of corporate offering in a month in history.

When I got to the office I opened the Horsey Chart Book and stared at the monthly, long-term chart of the Dow. On the opposite page was the long-term chart of the D-J 40-Bond Average. "Lord," I muttered to myself, "what are these two charts trying to tell us!"

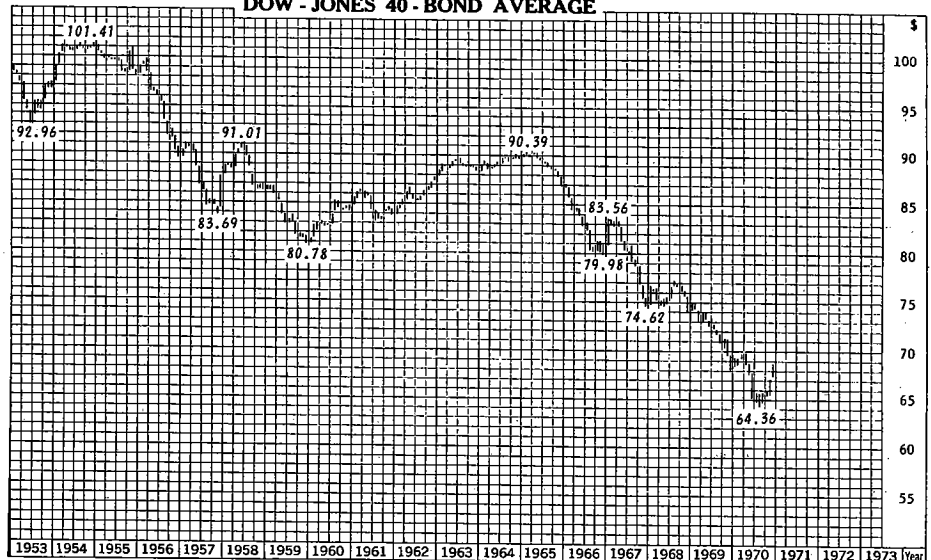
The bond chart is clear enough. The broad 40-bond Average has dropped from a 1954 high of 101 to a 1970 low of 64. Following the great collapse in interest rates in 1971, we find the 40-Bond Average has rallied back to around 71. Since most of the bonds in the 40-Bond Average are long-term debt instruments, it is obvious that the bond market holds little faith for the future. When the Fed moves, investors pour into the short and even intermediate-term bonds, but the long-term bonds have few friends.

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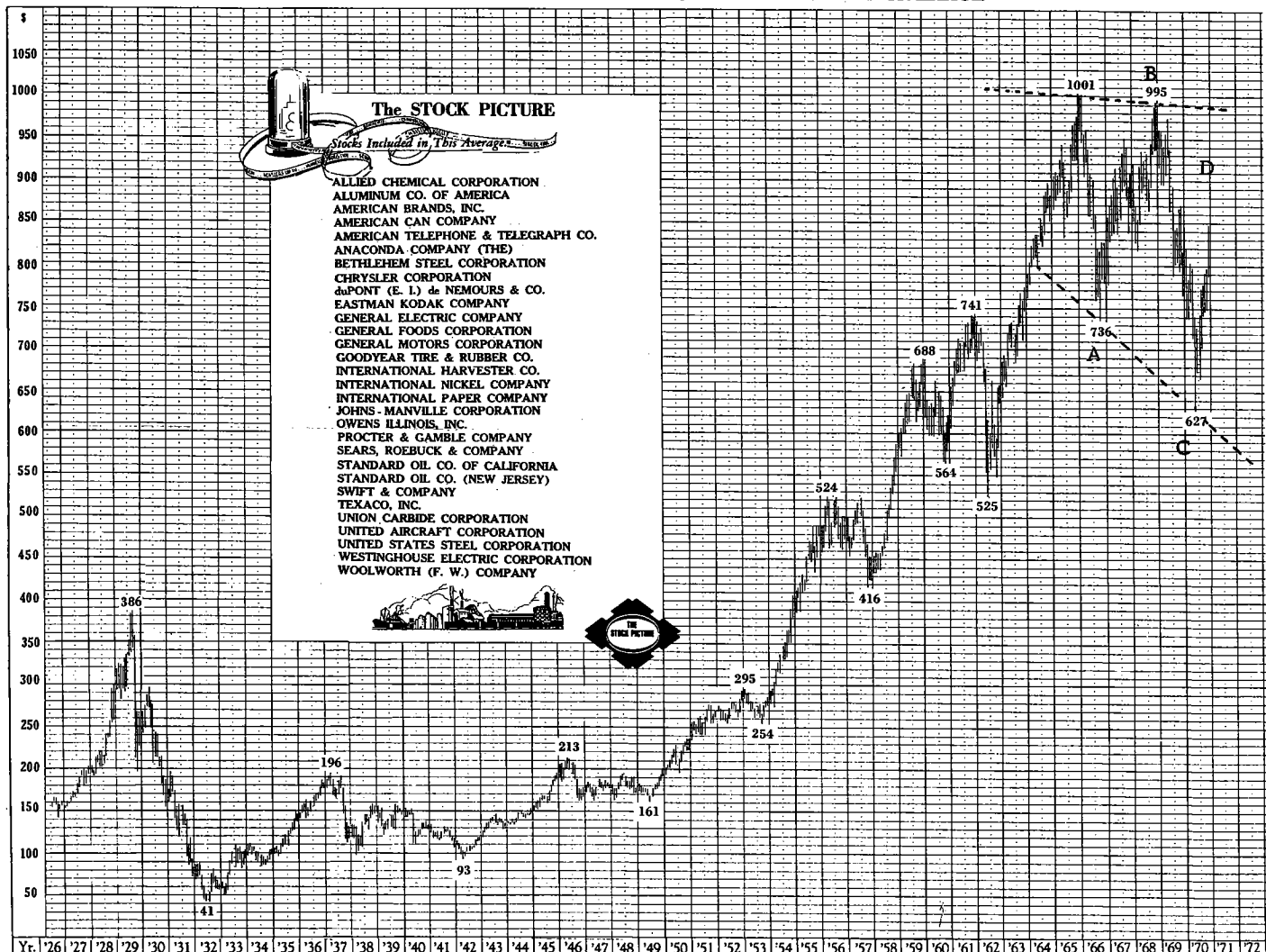
Consciously or unconsciously, bond buyers seem to sense two alternatives ahead, both bearish for the long-term picture. If inflation continues, long-term bonds are a poor investment. If deflation (and lower interest rates) are coming, bond buyers must sense a liquidity crisis and a rocky bond market despite lower interest rates. Either way, the rally in the D-J 40 Bond Average has been pitiful in the face of the Government's frantic efforts to ease money.

Turning to the Dow Industrials (see chart), I get the feeling that since 1966 the market has been tracing out the greatest top in history. Starting with the 995.15 bull market top of February, 1966, the Dow has followed an A,B,C,D, pattern of rising and falling legs. We are now on leg D, which, when it is completed, will represent the fourth leg of the bear market. Most bear markets trace out five major legs, and I do not expect this one to be any different. But I wonder, what will the fifth leg look like, how long will it last, and how far will it carry? To my mind, everything which has occurred so far (since 1966) appears

DOW - JONES 40 - BOND AVERAGE



DOW-JONES INDUSTRIAL AVERAGE



to be in the form of the preliminary, massive, unbelievable top. The "guts" of the bear market should appear with the fifth (downward) leg.

The first major bear leg (1966) carried from 995 to 744 on the Dow, a distance of 251 points. The second bear leg (1968-70) carried from 985 to 631, a distance of 354 points. The average Dow points lost on the two legs was 302 points. As a guess, I would not be surprised to see the fifth or final leg carry down double the average distance of the first two legs, or about 600 points from its peak ahead to its final bottom.

AUTOS: Many things have been bothering me about the auto business (see end of Letter 488), not the least of which is that mighty General Motors has been unable to regain even half of its 1965-70 losses. The auto industry has been one of the backbones of the American economy for the past half century, but for the first time U.S. auto are now facing vicious competition from foreign sources, changes in consumer tastes, together with a general glut of cars (plus numerous safety scares regarding cars of all kinds).

This led me to write to Mr. H.C. Ray (Ray Signals, 42 Broadway, N.Y.C. 10004), who keeps the best relative charts in the nation. He sent me his long-term (and I mean long-term) relative chart of the auto industry (group strength compared with the Standard & Poor 425 Industrials). What you see on this chart is not price, it is relative strength of the auto industry group price compared with a broad industrial average.

Note that the trendline I have drawn has held ever since the 1938 bottom! The trendline of relative strength was tested twice, once in 1946 and once in 1961. Each time that trendline held. The R.S. line touched its record high in 1964, and then turned down. In 1969 auto relative strength broke the trendline for the first time since 1938. Autos acted better than the market during most of 1970, but during the latter half the R.S. line again turned down. The decline has extended into 1971.

My guess is that the auto industry could be facing big trouble. Should the R.S. line break decisively below the trendline, I would say that the troubles will be long-lasting and severe, probably more severe than anyone now imagines.

